In the Supreme Court of the United States

OCTOBER TERM, 1967

No. 604

ROYALTON STONE CORPORATION, FRONTIER STONE PRODUCTS, INC., HOLMAN O'CONNOR AND MARY W. O'CONNOR, JAMES M. SWITZER AND DOROTHEA W. SWITZER, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

The question is whether payments received by the individual petitioners [1] for minerals removed from their land were capital gains or depletable ordinary income. The individual petitioners entered into purported "sales" agreements with the corporate petitioners, their wholly-owned operating corporations. The corporations were to quarry and remove sand, gravel, stone and associated materials from the indi-

[1] Since the individual petitioner-husbands were the only active parties to the transactions involved, they are referred to herein as "the individual petitioners".

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viduals' land and pay 20 cents per ton removed. The corporations were not obligated to extract any specific amount of the minerals or to pay any initial sum or guaranteed minimum sum; they could cease operations at any time with no obligation other than to pay at the specified rate for minerals removed. When and if all deposits were extracted, the land, which would then be virtually worthless, was to be conveyed to the corporations.

Petitioners treated the transaction as giving rise to capital gains to the individuals and as not giving the corporations the right to claim business deductions. The Commissioner determined deficiencies in the individuals' tax liability on the ground that the proceeds were depletable ordinary income. In a suit for a redetermination, the individual petitioners contended that the tonnage payments were capital gain from a sale. The court of appeals, affirming the Tax Court, held that the payments were in substance royalties paid pursuant to a licensing arrangement, taxable to the individual petitioners as ordinary income subject to the depletion allowance.[2]

1. The same basic issue was decided in favor of the government by the Fifth Circuit in *Wood* v. *United States*, 377 F. 2d 300 (C.A. 5). The taxpayers in *Wood*, and in a companion case, *United States* v. *Peeler*, 377 F. 2d 531 (C.A. 5), have filed petitions

[2] The corollary of this holding is that the corporations are entitled to deduct the tonnage payments in full as business expenses, and the Tax Court has made appropriate adjustments in the tax liability of the corporate petitioners for the taxable years.

for writs of certiorari in Nos. 471 and 475, this Term. The Commissioner is filing memoranda in opposition to those petitions at the same time as this memorandum is filed.

In the instant case, petitioners assert (Pet. 5) that certiorari should be granted for the reasons set forth in the petitions in *Wood* and *Peeler*. For our answers to those arguments, we refer the Court to our oppositions in those cases.[3]

2. Petitioners in addition contend (Pet. 5–6) that the decision here is in conflict with *Crowell Land & Min. Corp.* v. *Commissioner*, 242 F. 2d 864, where the Fifth Circuit held that a transfer of operating rights in hard minerals for payments measured by a per ton royalty was a sale in substance as well as in form, and entitled to capital gains treatment. But that case is inapposite, since, as the Second Circuit noted here (Pet. 12) the operating company in *Crowell* was required to pay a fixed amount over a fixed period, regardless of extraction.

Moreover, in its decision in *Wood* v. *United States, supra*, the Fifth Circuit has substantially restricted the precedential reach of *Crowell*. More particularly, in *Wood* the Fifth Circuit disapproved the strong emphasis in *Crowell* on the wording of the instrument as a contract of sale, stating that form is not "properly determinative of tax consequences under the economic interest test", and it also rejected *Crowell* as any precedent for the proposition that a

[3] Copies of those oppositions are being served on petitioners' counsel.

transferor of operating rights does not retain his "economic interest" where his royalty is measured by a fixed per ton royalty. (377 F. 2d at 311.) This restriction of *Crowell* was indeed required by this Court's prior decisions. For example, it is said in *Burton-Sutton Oil Co.* v. *Commissioner,* 328 U.S. 25, 32:

> Whether the instrument creating the rights is a lease, a sublease or an assignment has not been deemed significant from the federal tax viewpoint in determining whether or not the taxpayer had an economic interest in the oil in place. *Palmer* v. *Bender,* 287 U.S. 551, 557, 558.

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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